THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 401 **NOVEMBER 2006**

There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.

— Ludwig von Mises, *Human Action*, 1949

SUICIDAL TRADE DEFICIT

Looking into 2007, unquestionably, the greatest uncertainty is whether the U.S. housing bubble will end in a hard or a soft landing. A bust would have severe adverse implications for the world economy, given that the U.S. economy has been the key engine of global economic growth in recent years.

On the surface, it seems that there are diametrically different views at work in the markets. While the rising bond prices and the falling commodity prices apparently suggest underlying distinct economic bearishness, the sudden surge in stock prices and persistent record-low credit spreads appear to reflect very optimistic expectations about the economy.

The turn in the bond market started in June with yields of 10-year Treasury notes at 5.25%. A decline to 4.7% generated a 5% return for investors within just three months. Annualized, this comes to a return of 20%. Take further into account that there is generally heavy leverage involved, multiplying this return between 10–20 times.

Considering further that this rate of decline of long-term rates has occurred against the backdrop of a firmly inverted yield curve, implying that expenses of carry trade exceed current yields, the strength of this move seems a bit surprising. The quick capital gains, though, have richly offset these interest expenses — for the time being. But to maintain these highly leveraged positions, it will need at least one of two things: either a further sharp fall in long-term rates providing new capital gains or rate cuts by the Fed reducing the costs of carry trade.

More surprising is the new bull run of the stock market in the face of an economic slowdown. Approaching recessions have always tended to depress stock markets in expectation of falling profits. Well, there is a tremendous difference between past and present experience.

Past recessions were all triggered by true monetary tightening, hitting both the economy and the markets. The current economic downturn is unfolding against the backdrop of unmitigated monetary looseness. While the Fed has raised credit costs from unusually low levels, it has done nothing to tighten credit. Its expansion has kept accelerating.

Credit demand has been running wild for consumption, housing and financial speculation. There is just one striking and ominous exception: Corporate credit demand for fixed investment remains zero. Corporations, too, have been borrowing heavily, but for mergers, acquisitions and stock buybacks, not for productive investment.

In 2005, nonfinancial corporations spent $136.8 billion less than their cash flow from retained profits and depreciations on capital expenditures. Simultaneously, they spent $363.6 billion on mergers, acquisitions and stock buybacks. Given their moderate cash surplus, one has to assume that the stock purchases were generally financed with borrowed money.

It is certainly reasonable to regard the strong trend of corporate stock purchases as an early negative indicator of investment intentions. Principally, there are two different ways for corporations to expand and to raise profits. One is the old-fashioned way of organic growth through creating new plant and equipment. The other is to purchase economic growth and higher earnings through mergers and acquisitions by going more deeply into debt.

What, then, has been happening more lately to mergers and acquisitions? In short, they have gone crazy. During the first quarter of 2006, they hit an amount of $558 billion at annual rate, and in the second quarter another $554.8 billion.

This compares with continuously weak capital investment. In the first quarter, it was $2.7 billion below cash flow, and in the second quarter, $43.2 billion above cash flow. There is an interesting comparison with the year 2000. Then, capital expenditures of nonfinancial corporations exceeded their cash flow by $310.8 billion, compared with net stock purchases of $118.2 billion.

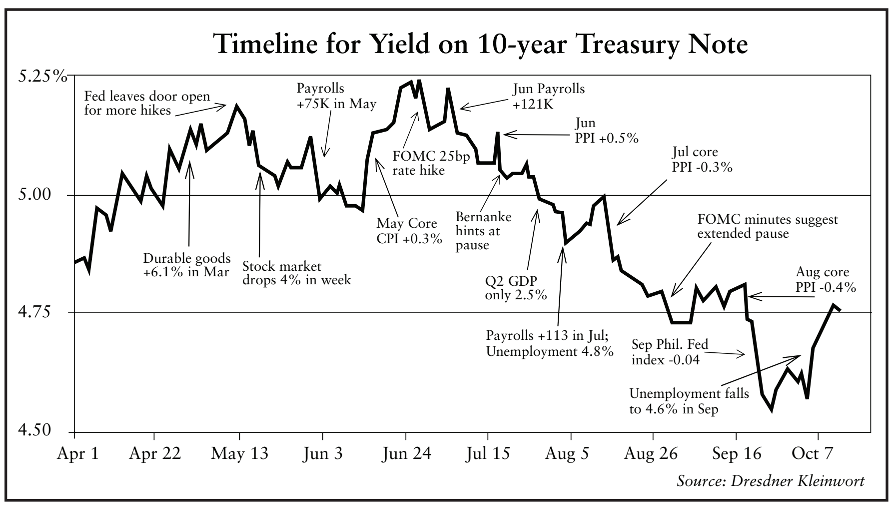
We would say that these figures indicate a continuous, rather dramatic change in corporate policies of expansion away from new capital investment and toward "purchasing" growth and earnings. It started in the 1980s. It strongly intensified during the 1990s, and during the last few years has gone to extremes.

Stating this, we primarily have the long-term development in mind. But in the same vein, we are pondering what is going to happen to business investment in the short run, when consumer spending slows, or even slumps, in the wake of the bursting housing bubble. The generally highly optimistic expectations and forecasts about investment spending taking over from consumption as the driver of the economy greatly puzzle us.

To stress one important point, which appears to be generally overlooked: Some rise in capital spending is not enough. Given its much smaller share of GDP than consumer spending, it needs a very strong rise to offset even a minor decline in consumer spending.

While the markets seem to reflect highly conflicting views about the U.S. economy's outlook, we nevertheless presume one underlying common view, and that is the perception of very little risk of a possible recession because the Fed would, in any case, swiftly act to head off any gathering weakness. What matters from this perspective both in the bond and stock markets are impending rate cuts.

In essence, this is in line with the conventional thinking that the U.S. Great Depression of the 1930s, as well as Japan's prolonged malaise since the early 1990s, could have been avoided by prompter monetary easing. Whoever believes in this is entitled to be bullish both on stocks and bonds.



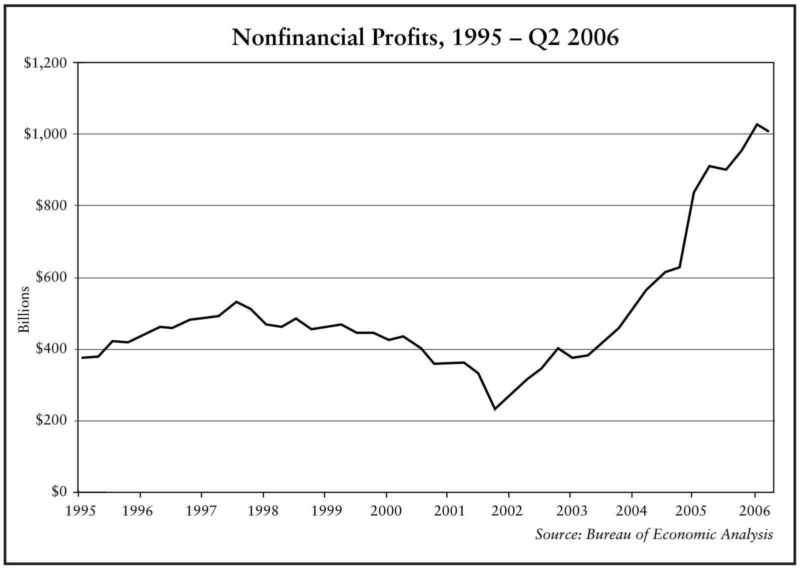
A STRANGE PROFIT PERFORMANCE

U.S. stock prices received their lift since June/July mainly from lower oil prices and lower long-term interest rates. To keep heading higher, it will now need sufficient earnings growth. After an unusually steep rise in profits during 2005, analysts are predicting more of the same. Our focus is on aggregate profits, as calculated and reported by the Bureau of Economic Analysis within the National Income and Product Accounts (NIPA).

The customary way of making forecasts of economic developments is to extrapolate the recent past. Profit growth in the United States during the last two years has been at its best for the whole postwar period. Profits of the nonfinancial sector in 2005 have jumped to $900.1 billion, from $584 billion in 2004 and $411.8 billion in 2003. These figures compare with a profit peak of $508.4 billion for the sector in 1997 and a profit low of $322.0 billion in 2001.

The next chart shows the profit development of U.S. corporations over the last 10 years. It is an awkward picture. Profits fared very poorly during the "New Paradigm" years of the late 1990s, presumably a time of

excellent economic performance. No less astounding is their sudden steep rise in the course of 2005, from $624.2 billion in the fourth quarter of 2004 to $1,027.7 billion in the first quarter of 2006, happening while the economy distinctly slowed.



The irony is that after a strong rise during the first half of the 1990s, profits abruptly turned down during the "New Paradigm" years of the late 1990s. For six years, from the recession year 1991–97, the nonfinancial sector's profits had soared from $227.3 billion to $508.4 billion. As a percentage of GDP, these profits had risen from 3.8% to 4.9%.

While "New Paradigm" ballyhoo and stock prices flourished after 1997, business profits, as officially measured, suddenly slumped. As a percentage of GDP, they were a little higher at the height of the dot-com bubble than in the recession year 1991.

Coming to the recent recovery years, we must point to some irritating observations. On the surface, it looks like a fabulous profit development. From recession year 2001 to 2005, profits of businesses in the nonfinancial sector have more than tripled, from $322 billion to almost $1,100 billion. It was the best profit performance of all time.

However, this good-looking total consisted of two extremely different parts. It was in the first quarter of 2004 that profits exceeded their peak of 1997 for the first time. From there, they shot up almost vertically. Typically, it has been inverse that the very first years of recovery were best for profits.

PROFITS TO FALL SHARPLY

Plainly, the extraordinary profit surge in 2005 cannot be explained with an improving general economic performance. GDP growth decelerated. Implicitly, it must overwhelmingly owe to special, temporary influences, of which we identified three: *first*, an unusually sharp decline in personal saving; *second*, a sharp decline in corporate consumption allowances; and *third*, a burst in tax-favored profit repatriations from abroad.

The fact is that in the U.S. economy, with its tremendous imbalances, business profits are exposed to extremely contrary influences. Record-low interest rates and record-high tax cuts were a very strong positive influence over the past few years. A very strong negative influence, on the other hand, has been the surging trade deficit, virtually doubling since 2001 to more than $800 billion per year recently.

The single most important profit source for the U.S. business sector during 2005 was an unusually sharp decline in personal saving, from 2% of disposable income in the prior year to negative 0.4%, amounting altogether to a swing of $209.1 billion.

As a matter of fact, the personal saving rate in the first half of 2006 has drastically deteriorated further — from minus $34.8 billion in 2005 to minus $97 billion (annualized) in the first quarter and minus $141 billion (annualized) in the second quarter. But what this further fall in personal saving reflected was not higher spending, but sharply lower income growth. In 2005, growth of real disposable income fell to 1.2%, after 3.6% in 2004. Private households offset the sharp decline in their incomes by still higher borrowing and lesser saving.

Why are changes in the personal saving rate so important for business profits? At issue is the connection between business expenses, consumer incomes, savings and profits. The starting point is the recognition that

business costs of production — salaries, wages, rents, interests, etc. — represent in the aggregate the incomes of the employed public acting as factors of production.

All expenses reduce profits; all revenues increase profits. If employees spend their total income, business revenues fall short of business expenses. In the aggregate, saving diminishes business revenues. Falling savings, in turn, increase profits. Generally speaking, changes in the savings rate are crucial for profits.

Even though the U.S. economy has significantly slowed after 2004, business profits nevertheless boomed. One major cause, as explained, was the phenomenal plunge in personal saving. The explanation is that consumers correspondingly spent more of their current income. Given the level of business expenses, aggregate profits rose.

A change in the personal saving rate by 1% at the present income level causes a gain or loss of profits of $90 billion for the business sector. Its decline during 2005–06 has been more than 3%. Considering that the housing bubble has been generating mortgage credit of more than $1 trillion per year, we expect that its bust will ignite a significant rise in personal saving, essentially at the expense of profits. Never forget, the existing excess liquidity comes from excess debt. True liquidity comes only from saving out of current income.

INVESTMENT, THE PROFIT KEY

Consumer spending is, of course, not alone as a stream of revenues for the business sector. The other main stream is the sector's own investment spending. It, too, has a most important peculiarity. It involves no expenses, from the macro perspective. While this may appear an absurd assumption, it has an easy explanation. Investment spending is not expensed in the profit-and-loss accounts until the first depreciation charge is recorded. It is capitalized in the firm's balance sheet. To the manufacturers of the capital goods, in contrast, the sale of the machines produces immediate revenue.

To emphasize, this is seen from the macro perspective for the business sector as a whole. In brief, it says that investment spending in excess of saving is the key to aggregate profit creation. Saving, to recall, reduces spending from current income at the expense of profits.

We hasten to add that the economic recovery in the United States during the past few years had nothing in common with this traditional pattern of economic growth and profit creation. For the first time in the whole postwar period, business fixed investment has been falling short of the current cash flow. In other words, there was zero contribution to profits from this source. It needed other profit sources.

Considering the huge amounts that corporations are spending on mergers and acquisitions, we have to emphasize that this kind of investment adds nothing to profits, because it involves no income creation, except for involved lawyers and the banks. The decisive economic element of investment spending is the associated income and employment creation.

Another major profit source for the business sector in the past few years has been the government, with the big swing in its finances from surplus to deficit. According to the Economic Policy Institute in Washington, the tax cuts added up to $860 billion. Implicitly, they correspondingly increased the incomes of the private sector, both businesses and private households.

Without question, the latter were by far the greatest direct recipient. But by their spending in the shops, it ended overwhelmingly with the business sector. The astonishing thing is that under these conditions, profits improved so little until 2004, and that had a specific reason.

THE GROSSLY MISJUDGED U.S. TRADE DEFICIT

American policymakers and economists keep proclaiming that the trade deficit is not posing any real problem for the U.S. economy. This general perception reveals an unbelievable ignorance of macroeconomics.

The trade deficit causes an equivalent direct loss of production, incomes, profits and wealth on the part

of the U.S. economy to the rest of the world. Its external counterpart is a corresponding increase in foreign indebtedness reducing American wealth.

Due to the trade deficit, the ratio of domestic production to domestic consumption in the U.S. manufacturing goods market has, according to calculations by the Economic Policy Institute, dropped from 92% in 1997 to 78.2% in 2005, a decline equivalent to $420 billion of manufactured output. Chinese manufacturing accounted for 36% of this decline.

China's Share of U.S. Markets for Manufactured Goods (1997 and 2005)

	U.S. share			China share		
	1997	**2005**	**change***	**1997**	**2005**	**change***
Manufacturing total	92.0%	78.2%	–13.8	2.7%	7.8%	5.1
Durable goods	90.1%	75.4%	–14.8	2.9%	9.7%	6.8
Nondurable goods	94,9%	82.6%	–12.3	2.5%	5.0%	2.4

*change in percentage points

Source: Bureau of Economic Analysis, Economic Policy Institute, Washington

The general deceptive argument about the trade deficit is that inflows and outflows simply offset each other. True, the two flows are of identical size. But what matters is that their effects on the U.S. economy are diametrically different. Moreover, both flows are of evil nature. The trade deficit dislocates the whole economy, while the capital inflows distort the pricing in the financial system.

Another important question is the causality between the two flows. Is the trade deficit driving the capital inflows? Or are the capital inflows driving the trade deficit?

Both Mr. Greenspan and Mr. Bernanke have postulated in public speeches that the U.S. trade deficit has everything to do with foreign policies and nothing to do with U.S. policies. The key cause, in their view, is the fact that the phenomenal rise in U.S. productivity growth is attracting foreign savings toward investment in the United Sates. Somehow, the trade deficit mysteriously becomes the mirror image of the capital surplus.

Mr. Bernanke gained particular attention with a speech in which he attributed the U.S. trade deficit to the "*emergence of a global saving glut in the past eight to ten years*," while in the United States at the same time "*the rapid increase in household wealth and expectations of future income gains reduced U.S. residents' perceived need to save*."

MIRROR-IMAGE NONSENSE

Utter trash. The first blatantly contradictory point to this convenient explanation is that most of the dollars flowing out through the trade deficit are purchased by foreign central banks for reasons obviously other than U.S. productivity and profits. The unambiguous purpose of these purchases is to prevent an appreciation of their currencies against the dollar. In essence, this acts as a subsidy to their exporters. We cannot imagine that Mr. Greenspan and Mr. Bernanke are blind to this fact.

In any case, there is a second compelling reason why the U.S. trade deficit cannot be ascribed to the capital inflows. It has to do with the exchange rate system. The economic impact of capital flows differs diametrically, whether a country has a fixed or a flexible exchange rate.

Under fixed exchange rates, the central bank buys up the currency surplus. This floods the banking system with excessive bank reserves. Acting as high-powered money, this sparks off an accelerating credit expansion. As a result, the economy and the markets overheat. To emphasize, this is what happens to a country flooded with capital inflows under fixed exchange rates. In short, it creates liquidity excess and inflation.

But under a system of flexible exchanges, as operated in the United States by the Federal Reserve, the economic and monetary effects of capital inflows differ diametrically from the experience under a fixed exchange rate. Under this system, compelling the central bank to rigorous abstinence from intervention in the currency markets, there is no flow of money between countries. Banks in the capital-importing countries are not gaining any reserves. Nor do the banks in the capital-exporting countries lose any reserves.

Attributing the U.S. trade deficit to capital inflows essentially implies that U.S. foreign trade would otherwise

be in balance. Yet foreign investors want to buy large amounts of dollar assets. Since the Fed refuses to supply the necessary dollars, the markets have to make them available.

How do they do that in the case of a country with flexible exchange rates? In short, this occurs through the exchange rate mechanism. Wanting to buy dollar assets, foreign investors first have to buy dollars. Doing so, they drive up the dollar in the currency markets. Curbing U.S. exports and stimulating U.S. imports, this brings about a trade deficit. The dollars that foreign investors need to buy dollar assets must be made available by a U.S. import surplus.

But it is grotesque to explain the U.S. trade deficit in this way. Under flexible exchange rates, as explained, capital inflows produce precisely opposite results to those under fixed exchange rates. There is no addition to domestic liquidity, while the surging dollar, through the surging trade deficit, would have depressed the U.S. economy. A trade deficit of such monumentality would have driven the U.S. economy into depression, not just recession long ago.

Implicitly, the U.S. trade deficit is made in the United States, and its cause is also blatantly obvious: boundless credit excess, engineered by the Fed, fueling consumption at the expense of saving and investment.

Let us first have a look at the different reciprocal effects. What makes the crucial difference between the two flows is the fact that spending through the two components of the balance of payment occurs in entirely different markets. The trade deficit impacts the economy, while the capital inflows impact the asset markets outside the economy.

The trade-related spending-outflow diminishes U.S. gross domestic output, production, incomes and profits. In turn, the capital inflows purchase U.S. assets, primarily government bonds. Manifestly, these purchases of existing assets do not recoup any of those losses caused by the trade deficit. Put differently, the trade deficit ravages manufacturing, while the capital inflows benefit Wall Street and the government. Manifestly, there is a flagrant conflict of interest. Whose interests are dominant in this case is flagrantly clear.

However, we must immediately qualify this remark. Lower interest rates and higher asset prices owing to the capital inflows, of course, please Wall Street and policymakers. But from the perspective of the economy as a whole, they are of evil nature by distorting prices in the financial system.

These capital inflows reflect a huge flow of saving, but it is foreign saving, not American saving. Yet it has the same positive effects on U.S. interest rates and asset prices as domestic saving. Implicitly, the U.S. economy ends up with huge permanent monetary looseness. We guess that this is widely desired, policymakers included.

The next point to see is that the big trade-related U.S. losses in spending and incomes are meanwhile of a size to jeopardize economic growth. To maintain domestic spending nonetheless, the Fed has to generate additional credit through a relatively looser monetary policy. The resulting alternative domestic spending, however, is essentially different from the demand that exits through the trade deficit. The gains are overwhelmingly in services, largely with low pay. Manufacturing is the outstanding loser.

There is no doubt that the trade deficit — having virtually doubled over the last five years — has played a most important role in grossly disarranging the U.S. economy. The results are strikingly obvious in its anemic recovery ailing from unprecedented shortfalls in capital spending, employment and incomes on one side, and unprecedented debt growth on the other.

CAPITAL SPENDING CRISIS

The decisive dominant shortfall in the U.S. economy's recovery from the 2001 recession has been in business fixed investment. In 2000–02 it suffered its greatest decline in the postwar period as a share of GDP, and has by this measure during the recovery increasingly lagged, taking into account that this owes mostly to the hedonic pricing of computers.

In current dollars, U.S. GDP over the period 2001–05 has risen 23%. Business fixed investment, in contrast, rose merely 7.5%. In real terms, an increase in GDP by 16% between 2000 and the second quarter of 2006

compares with a simultaneous rise in nonresidential investment by 5.7%.

Over the five years of economic recovery, the growth rate of business fixed investment has been just one-third of the growth rate of GDP. Consumption, by the way, grew 19.5%, even faster than GDP. Clearly, this extraordinary shortfall of business fixed investment is structural.

What are the reasons for this capital spending crisis, and are these reasons receding or not? From the macro perspective, this unusual weakness of business fixed investment has one main cause, and that is a major change in the U.S. economy's resource allocation. As aggressive consumer spending, including residential building, has absorbed a growing share of GDP, the necessary productive resources had to be pulled from somewhere else.

This occurred through two channels. One was the soaring trade deficit pulling in manufactured goods from abroad, and the other was the displacement or crowding out of domestic investment. Specifically, capital-intensive U.S. manufacturing is crowded out.

CAMOUFLAGING INFLATION

But there is another most important effect to the trade deficit. On the surface, it seems of very positive nature. In reality, it is equally evil. This effect is that it distorts the U.S. inflation rates substantially to the downside. Since the inflation rates are the Fed's key policy gauge, this distortion of the inflation rate leads to persistently excessive monetary looseness.

As pointed out, the nitty-gritty of the huge trade deficit is that it diverts a corresponding amount of domestic spending on manufactured goods — presently at an amount of more than $800 billion per year — away from domestic producers and toward foreign producers. It is self-evident that U.S. inflation rates in the absence of this massive diversion of domestic demand would be several percentage points higher.

And something else would be correspondingly much higher: U.S. interest rates. As sharply higher inflation rates would have forced the Federal Reserve to a rigorous tightening of its credit spigots, there would have been much weaker economic growth, and above all, there would have been no wealth creation through rising stock and house prices, but wealth destruction through falling stock and house prices. Of course, it can be argued that in this way the trade deficit has been highly beneficial to the U.S. economy. The old economists would say that this essentially creates dangerous imbalances, to end in a bust.

Rising inflation rates and a rising trade deficit have implicitly one and the same cause: an excess of domestic spending over domestic output. Until the late 1970s, excess demand used to show mainly in rising inflation rates of consumer and producer prices, which tended to trigger monetary tightening.

Money and credit expansion since the 1980s in relation to economic activity, as measured by GDP, has rapidly escalated. Credit excess in most countries is more rampant than ever before, but the effects are overwhelmingly showing in rising trade deficits and asset prices, while the traditional inflation rates remain subdued. Intriguingly, the latter has been providing the central banks with the justification for continuous monetary looseness. Essentially, imbalances proliferate.

Now to the unpleasant conclusions: The important thing to recognize about the huge U.S. trade deficit is that it grossly distorts U.S. inflation rates to the downside because America virtually exports its rampant domestic inflation through its huge dollar outflows to the rest of the world.

Pondering inflation, it is necessary to distinguish between its various effects and its single cause. The single cause is excess credit creating excess demand and spending in relation to potential domestic output. But depending on domestic and global circumstances, the excess demand may boost domestic inflation rates or spill over into an import surplus.

Completely failing to recognize this causal connection, American policymakers and economists celebrate the record-low inflation rates as the product of superior productivity growth, justifying low interest rates and loose money, while celebrating the trade deficit as an emblem of economic strength. The paradox result is that the

grossly understated U.S. inflation rates mislead or allow the Fed to continue its extraordinary monetary looseness.

TARGETING A BUBBLE ECONOMY

As a matter of fact, we have great difficulty believing that the monetary experts in the Fed are truly innocent in this matter. To be sure, they do not want to see it, because the lower inflation rates are the essential condition for the low interest rates with which they have fueled the desired rampant "wealth creation," first in equity, then in housing.

Unmistakably, this wealth creation is highly desired. It is a main positive argument about the economy's recovery. Understandably, the Federal Reserve and Wall Street declare it impossible to recognize an asset bubble before it bursts, because they fervently want and need the bubble for its prodigious "wealth creation." From this perspective, it is a "virtuous circle."

It is hard to believe, but that is what Mr. Greenspan rather freely admitted in a congressional testimony on June 10, 1998:

> *In short, our economy is still enjoying a virtuous circle, in which, in the context of subdued inflation and generally supportive credit conditions, rising equity values are providing impetus for spending and, in turn, the expansion of output, employment and productivity-enhancing capital investment. The hopes for accelerated productivity growth have been bolstering expectations of future corporate earnings and thereby fueling still further increases in equity values.*
>
> *The essential precondition for the emergence, and persistence, of this virtuous circle is arguably the decline in the rate of inflation to near price stability. Continued low product price inflation and expectations that it will persist have brought increasing stability to financial markets and fostered perceptions that the degree of risk in the financial outlook has been moving ever lower. These perceptions, in turn, have reduced the extra compensation that investors require for making loans to, or taking ownership positions in, private firms.*

Reading these two paragraphs carefully, one realizes that Mr. Greenspan very much appreciated the equity bubble in the late 1990s, hailing its inherent *"impetus for spending"* through the rising asset prices as a *"virtuous circle."* Where, indeed, would there be any prosperity in the U.S. economy without this phony wealth creation through rising asset prices?

ASSET BUBBLES EQUAL DRUGS

It has become customary in the United States to speak of "asset-driven" economic growth. "Asset-driven" is, of course, a euphemism for bubble-driven, because it requires particularly large rises in asset prices.

It is generally being talked of as a valid alternative to the traditional growth pattern, nowadays so-called "income-driven" economic growth. Here, too, the designation itself is first of all grossly misplaced. Income growth is never a driving force in economic growth. It essentially results from spending — actually, from credit-financed spending.

The U.S. economy's downturn and recovery over the past five years started with unusually sharp declines in business fixed investment and employment, followed by chronic weakness in both aggregates. The common third result was extraordinarily slow growth of personal incomes.

With unusually aggressive interest cuts, public deflation talk and hints that Fed purchases of T-bonds are an option to lower long-term rates further, the Federal Reserve systematically created the conditions for the emergence of the housing bubble, apparently with the deliberate intention to thereby provide a strong stimulus to consumer spending.

In the past, interest rate cuts stimulated borrowing for consumer or investment spending directly. Asset prices used to respond rather moderately to changes in monetary policy. Their violent reaction to monetary

easing with outsized wealth effects started only in the course of the 1980s, without any intention on the part of the Paul Volcker Federal Reserve.

Mr. Greenspan, as the earlier quotation reveals, gained high regard in the late 1990s for the impetus that rising stock values were providing to consumer spending. Plainly, this inspired him to the deliberate creation of the housing bubble. A new, indirect and apparently more efficient method of stimulating consumer spending through intermediation of an asset bubble was invented.

It seems to have two great advantages. Asset prices respond very fast and provide borrowing facilities with high leverage. But if these are advantages, they cannot be regarded in isolation. In question is, implicitly, the quality of the U.S. recovery that this new policy stance of driving economic growth through "wealth creation" has brought about.

For obvious reasons, the bullish publicity concentrates on the two best-looking statistical aggregates as the key measures of economic performance. That is, real GDP and productivity growth. As a rule, they are in line with what people actually experience in the incomes they earn and the prices they pay in the shops. But this time, there is an unprecedented gross discrepancy between the very good looks of these two aggregates and what they experience in actual life. It is an open secret there is extensive statistical spin.

Frankly speaking, we liken asset bubbles and associated credit bubbles with drugs. As human bodies become dangerously addicted to drugs, economies can become dangerously addicted to these bubbles. Of course, drugs cause severe damage to body and soul, and so do asset and credit bubbles to the economy and its financial system. In the U.S. case, these damages are highly visible. See the collapse of saving, the monstrous trade deficit, the capital spending crisis, miserable employment and income growth and, on top of that, the debt explosion devastating balance sheets.

WHEN RECESSION BECOMES INEVITABLE

These are definitely the attributes of pathological, unstable and unsustainable economic growth. These are more than just symptoms, because they exert their own malign effects. The decisive problem is that the instigated credit bubble does not evenly distribute across the economy. It concentrates on one or two areas, which expand out of proportion to trend growth. In the U.S. case, the credit excess has centered on durable goods, housing and financial speculation.

Put differently, asset and credit bubbles distort the economy's demand and output structure in an unsustainable way. At some point in the future, the related spending excesses flag, either under the pressure of credit tightening or on their own accord. Depending on their size, the bubble economy slides into recession.

Have the borrowing-and-spending excesses of the past years in the United States been of a size to make a severe adjustment crisis and deeper recession possible or probable? That is today's most important question, not only for the U.S. economy, but for the world economy. A crucial related question, of course, is the U.S. economy's resilience and flexibility to resist the coming adjustment shocks.

According to forecasts, the consensus economists expect the U.S. economy to see little more than a brief and minor economic slowdown from the housing blow. Basically, it is still in their eyes a "Goldilocks" economy, its outstanding emblem being low inflation interest rates.

For American economists, it is dogmatic that low inflation rates are the infallible indicator of economic health. The U.S. Great Depression of the 1930s, and also Japan's prolonged economic malaise, both having followed many years of a stable price level, should have taught a lesson about the inadequacy of this aggregate as a measure of health and a guide for policy.

Ironically, U.S. inflation rates in the present global environment in the first place are anything but low. Considering, in addition, the massive diversion of inflated domestic demand through the trade deficit to foreign producers, the boast about a low inflation rate is absurd. Taking the influence of the trade deficit into account, the U.S. economy has the worst inflation in the postwar period. Its compelling proof, by the way, is in the

runaway credit expansion exceeding real and nominal GDP growth as never before.

The key point about the U.S. economy, really, is that the forces that caused the 2001 recession never went away. They went from bad to worse. Business fixed investment has not really recovered from its slump in 2000–02. Its recovery in the following years has been far too weak to offset the prior loss. The counterpart and implicit cause of this capital spending crisis are the spending excesses on consumption and housing absorbing a growing share of GDP.

In 2005, consumer spending and the housing bubble accounted for 90.1% of real GDP growth. Now consider the following two figures: Real disposable income of private households grew 1.2%. This compared with an increase in real consumer spending by 3.5%. That is, spending rose three times as fast as disposable income.

It is no secret what made this incredible discrepancy between the two aggregates possible: equity extraction against inflating house prices. In 2000, disposable personal incomes increased by $354.5 billion in current dollars, and by $93.8 billion in chained dollars. Outstanding mortgages soared by $1,080 billion. That was 10 times faster than real income growth and three times faster than nominal income growth. Net worth — the increase of asset values minus the increase in total liabilities — rose $5.3 trillion, to $53.3 trillion.

Over the four years 2001–05, outstanding mortgages of private households have jumped from $5,292.9 billion to $8,888.1 billion, or 68%. Apparently, the housing bubble was not only the icing on the cake. It was the cake.

UNITED STATES — CHINA

In its most recent assessment of foreign trading partners' exchange rate policies, the U.S. Treasury Department refused to state that China is manipulating the value of its currency to enhance the international competitiveness of its economy. Measured by its soaring dollar purchases and soaring bilateral exports surplus with the United States, and considering also that Chinese wages are a fraction of American wages, it is a compelling conclusion that China is not only manipulating its currency, but that it is doing so to an unprecedented excess in history. These dollar purchases, preventing a rise of China's currency, act as a de facto subsidy to Chinese exports into the U.S. market.

The reason for the American silence is not difficult to guess. As earlier explained, there is a flagrant conflict of interest between manufacturing, on one side, and Wall Street and the government, on the other. China is the single biggest buyer of U.S. bonds in the world. Total reserves of its central bank are now close to $1 trillion. This is up from $165 billion in 2000.

The bilateral U.S.-China surplus (as measured by the U.S. government) in 2005 amounted to $203 billion. This is calculated Chinese imports and exports from its top 40 trading partners, covering around 90% of its total trade. This surplus has risen from $84 billion five years ago. China's officially reported trade surplus is only $46 billion.

The surplus with the United States represented over 9% of China's total GDP and compares with a global current account surplus of now 7% of its GDP, up 5 percentage points in five years. China is running deficits with other Asian countries.

China's international reserves of now close to $1 trillion constitute about 40% of its GDP. The composition of these reserves is secret, but estimates of experts put the dollar share at about 70% of the total. Essentially, the share of China's purchases and holdings of dollars is determined by the need to maintain the fixed exchange rate. The rapidly growing mountain of foreign currency has been generated by a swelling trade surplus, investment and speculative inflows.

There are no signs of any near-term change in its exchange rate policy. At the top of the list of objections is the feat of a negative impact of a rising exchange rate on exports. Yet another consideration stands out. The leading Chinese policymaking elite is convinced that Japan's lengthy recession has its root cause in the steep rise of the yen, which the Japanese authorities accepted under American pressure in the later 1980s. They are determined not to allow this to be repeated in China. In the same vein, there is a widespread view that exchange

rate stability is important for financial stability.

This is diametrically opposite to the thinking in Japan. Faced, too, with strong upward pressure on the yen, owing to a large trade surplus and capital inflows, the Japanese authorities responded with heavy dollar purchases, but not sufficiently to prevent an additional steep rise of the yen against the dollar.

Which of the two responses, now, was the fatal one that led to Japan's later great economic and financial malaise? For Japan's authorities and experts, the central bank's large dollar purchases were without any doubt the main culprit. By flooding the banking system in this way with excess liquidity, the following credit explosion propelled the two asset price bubbles in equity and real estate, which, in turn, fueled the related investment booms.

At the root of Japan's protracted malaise is manifestly the later bursting of these two bubbles; and these bubbles had their immediate cause just as manifestly in excess liquidity, which the Bank of Japan created with its large dollar purchases.

An appreciating currency, on the other hand, has effects that are diametrically opposite to those of generating asset and credit bubbles. On balance, it has strong deflationary effects, primarily hitting manufacturing. Curbing investments and exports, this would slow the economy. But this allows the central bank to slash interest rates. In essence, this would set in motion a very painful shift in the economy's resource allocation, lowering its manufacturing share in favor of services.

The trouble with the opposite policy of heavy dollar purchases and suppressed currency appreciation is that its effect on the economy's structure is exactly opposite. Instead of restraining manufacturing, it leads to a booming economy with progressive overexpansion of manufacturing and ever-larger export surpluses. At the very least, China ought to raise interest rates to slow credit demand and investment, but that is impossible. With the fixed exchange rate, it would most probably accelerate capital inflows, flooding the banking system with still more "high-powered" reserves.

There is a view that a central bank facing this problem of creating excess liquidity through purchases of a foreign currency can offset this effect by "sterilizing" these purchases through sales of domestic assets, immediately absorbing the excess liquidity. That is what China's central bank has been doing. For this purpose, the central bank sells short-term securities, most of which have a maturity of one year, and some even less.

From the perspective of monetary sterilization, these open market sales are an outright farce, because the papers, which the commercial banks receive from the central bank in exchange for the dollars they sell, represent top domestic liquidity for them, fostering credit expansion. In addition, the central bank releases them from the exchange risk.

Genuine sterilization of the dollar purchases would require that the central bank sell long-term paper to nonbanks, adding nothing to bank liquidity. During the past few years of rock-bottom U.S. interest rates, it made a loss on its interest account.

Some economists see in the economic and financial relationship between the United States and China a lucky symbiosis. One delivers the necessary demand for both by massive dissaving, and the other delivers the necessary supply by massive saving and investment.

The Americans make their spending excesses in consumption, and the Chinese make their spending excesses in productive investment. There are many absurd ideas around explaining why Americans enjoy the privilege of being able to have their cake and eat it too.

First of all, American policymakers and most economists are manifestly blind to the severe and growing structural damage that the trade deficit at its present size is doing to the U.S. economy's ability to create employment, incomes and capital formation. Economic growth will progressively slow.

But what about the Chinese economy's pattern of growth? Is that sustainable? It is definitely not. The main reason is that the permanent investment boom gets increasingly out of line with domestic consumption demand, resulting in an ever-larger export surplus. In turn, China's economic growth becomes ever more dependent on

rising exports. The trade surplus in the third quarter alone was $49 billion, versus $32 billion for the whole of 2004.

Pondering how China's reckless bubble policy will end, we look at Japan's experience as an example. We take it for granted that China's central bank, in contrast to the Bank of Japan, will accommodate this dollar-driven expansion as long as it works. Meanwhile, investment excesses are going to ever greater extremes, in mirror image of the consumption excesses in the United States.

The collapse of the asset and credit bubble happens at the latest when the banks become frightened of the soundness of their soaring loans. We realize that in China, with banks generally government owned, the lending excesses and malinvestments can go to extremes unimaginable in free market capitalistic economies.

But considering that the export surplus with the United States presently accounts for about 10% of China's GDP, we expect severe repercussion for China from a sharp economic slowdown of the U.S. economy.

CONCLUSIONS:

While U.S. real economic data overwhelmingly keep surprising on the downside, comments by economists and the media keep surprising on the upside. According to a count by Kleinwort Benson (Dresdner Bank), the frequency with which the word "Goldilocks" is mentioned in the financial press has risen to its highest level since the word came into vogue as a description of the ideal U.S. economic environment.

This is grotesque. Compared with 2000, when the last downturn started, the U.S. economy's growth fundamentals — savings, investment and the trade balance — have dramatically worsened. Debts, in particular of private households, have escalated as never before.

American economists have quickly decided that, after a brief lull, the next recovery is just around the corner. Its perceived lubricants are the fall in the oil price and in the long-term interest rate.

A whole variety of downward forces on the economy is studiously disregarded. The most important first consideration has to be that the bust of the housing bubble, with major negative implications for housing activity and consumer borrowing and spending, has barely started. Wealth effects have disappeared and with falling house prices — given the tremendous prior excesses — will turn substantially negative.

The most important data to watch in the coming months are house prices. Their rise was the foundation of the economy's recovery. Any significant fall will abort it, providing a boost to saving out of current income.

THE RICHEBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by Agora Financial, LLC
Addison Wiggin, Executive Publisher
Mandie Boardman, Marketing Manager

Richard Barnard, Associate Editor
Erik Kestler, Editorial Assistant
Beth Walk, Editorial Assistant
Susanne Krueger, Graphic Design

AGORA FINANCIAL